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“Avoiding Duplication in Matrimonial Proceedings”

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**AVOIDING DUPLICATIVE AWARDS
IN MATRIMONIAL PROCEEDINGS**

BY JOHN R. JOHNSON

Originating in the *O'Brien*¹ decision in 1985 and culminating with *McSparron*², the issue of *enhanced earnings* has posed complicated and unique problems for New York State's judiciary, its matrimonial attorneys and forensic valuers. Collectively, we have struggled with such issues as the methodology itself, separate property considerations, nexus between the attainment and an earnings enhancement, interplay with a professional practice, spousal contribution and others, not the least of which is the avoidance of duplicative awards. The challenge has been to properly convert a future earnings stream into *property* subject to equitable distribution, and then ensure that the value of other items of property, as well as maintenance and support awards, do not incorporate the same earnings in their determination. Many legal practitioners believe that this duplication issue is confined to proceedings involving licensed professionals, and even then, exclusive to New York. In reality, the problem of duplication encompasses a far wider range of situations and is germane to cases in every jurisdiction across the country. Before solutions can be implemented, however, we must first develop an understanding of how earnings streams are incorporated into asset values. Once understood, we can then address the duplication issue and explore possible solutions.

¹ *O'Brien v. O'Brien*, 66 NY2d 576, 583, 498 NYS2d 743 (Court of Appeals, 1985)

² *McSparron v. McSparron*, NYS Dec 8, 1995, p. 27, col. 3 (Court of Appeals)

Professional Licenses and Advanced Degrees

The problem of potential duplicative awards was originally brought to light when the New York courts first ruled that enhanced earnings capacity associated with a professional license and/or advanced degree is a marital asset to be valued and distributed between the spouses. Although not a new concept for professional valuers, this was the first time that the concept of *earnings* converged with the concept of *asset* in a matrimonial setting. The valuation process for enhanced earnings, to explain it briefly, involves the determination of the tax impacted enhanced earnings capacity of the holder attributable to the license or degree, and the calculation of the present value of these enhanced earnings over the expected worklife of the holder. The duplicative award problem occurs when the earnings stream used to value the license or advanced degree is then used again to determine professional practice values, maintenance and even child support. When a court awards a portion of a license or degree to a non-titled spouse, it is effectively giving away a portion of the titled spouse's future earnings stream. In awarding spousal maintenance and child support, the court runs the risk of giving the same earnings away again, unless certain adjustments are made.

The courts have recognized that the awarding of a portion of the value of a license, professional practice, and spousal maintenance could be duplicative to the extent that the value associated with each is based on a common earnings base. The Court of Appeals clearly warns of this potential inequity in *McSparron*. With regard to the overlap between the value of a license and a professional practice, the court stated:

"...care must be taken to ensure that the monetary value assigned to the license does not overlap with the value assigned to other marital assets that are derived from the license such as the licensed spouse's professional practice."

A careful reading of this excerpt underscores the fact that the license value and practice value are separate and distinct from each other. When the court's instruction is considered in conjunction with the financial analyses required to value a license and professional practice, the logical order of the steps required for a valuator to determine the license and practice value becomes clear. It is generally held in the professional valuation community that the order of valuation is professional practice *first* and professional license *second*. Although the author has heard many reasons why this should be so, the most convincing is that the risks associated with professional practices are more easily identified and quantified since the value can be determined within the parameters of actual practice sale transactions. This makes the valuation of professional practices somewhat less subjective than the enhanced earnings associated with licenses and degrees. Additionally, by valuing the practice first, the riskiest portion of the earnings stream is incorporated into the practice value, as shown in the Chart 1 below. This leaves a much less risky earnings stream available for the enhanced earnings calculation, where future risks and uncertainties are difficult, if not impossible, to quantify.

Here are the general steps that should be followed:

- Step 1:*** Determine the actual earnings which give rise to the practice and license value.
- Step 2:*** Determine the normalized income attributable to the professional practice in excess of the reasonable compensation to the owners (which is usually the subject of a valuation normalization adjustment) and a fair return on tangible assets.

This is described in Revenue Ruling 59-60:

"In the final analysis, goodwill is based upon earning capacity. The presence of goodwill and its value,

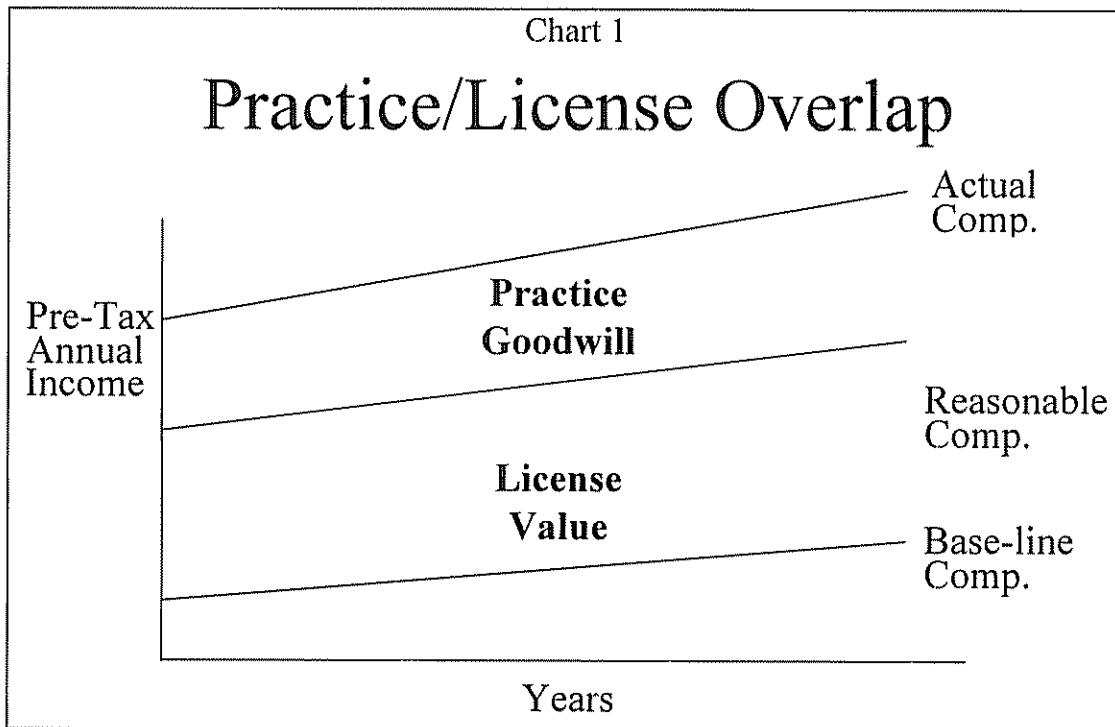
therefore, rests upon the excess of net earnings over and above a fair return on net tangible assets."

While Revenue Ruling 59-60 refers specifically to excess earnings relative to tangible assets, it assumes that a level of reasonable compensation has been incorporated into the earnings.

Step 3: Value the practice goodwill using the earnings determined under Step 2.

Step 4: Using the same reasonable compensation level used in Step 2 as top-line earnings, calculate the value of the license.

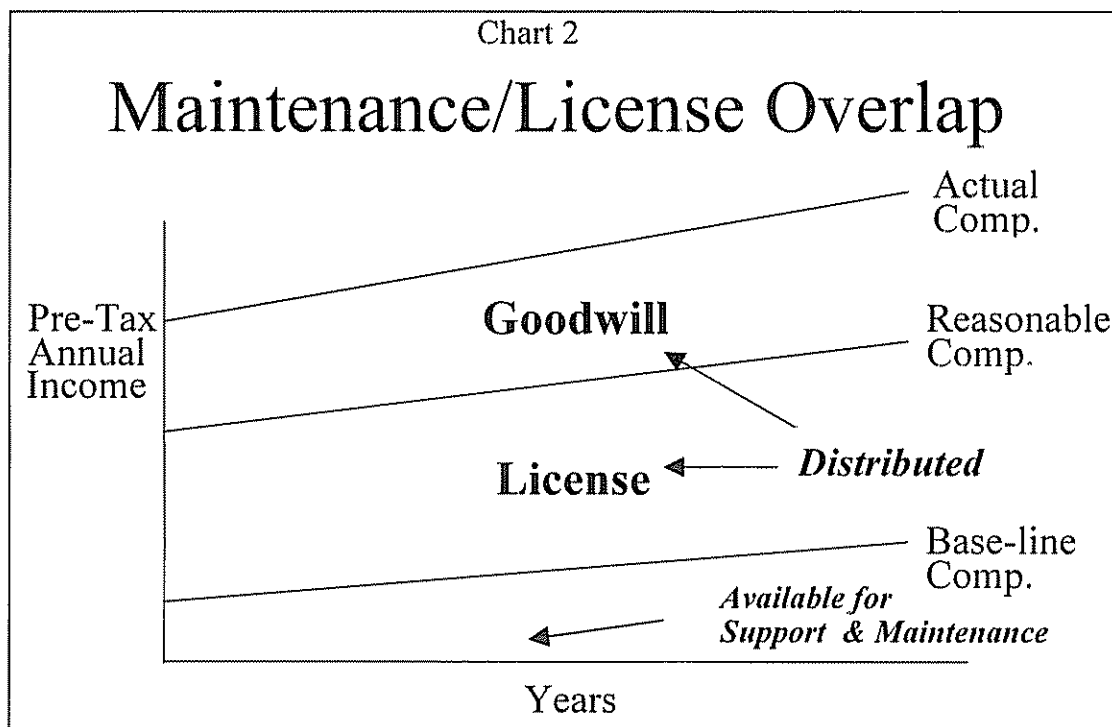
The simplified chart below illustrates the various components of the license and practice goodwill values. For simplicity, pre-tax incomes are shown, even though licenses are valued on an after-tax basis.



License/Maintenance/Support/Practice Overlap

The other area for potentially duplicative awards involves the interaction between spousal maintenance and license value. The Court of Appeals in *McSparrow* warned against “*duplication in the form of maintenance awards that are premised on earnings derived from professional licenses.*” The underlying concept in this statement is that once the value of the property has been distributed, the earnings stream which generates the value should not be revisited in an award of maintenance. Failure to set aside the portion of earnings which have already been considered in the valuation of the license could result in maintenance and child support awards which encroach upon the value of the distributed property.

From the method in which we determine license value, it is clear that all earnings above a pre-determined ‘baseline’ (many times the earnings of a college graduate) are already incorporated into the license and practice value. This indicates that pre-tax baseline earnings may be the only earnings which have not been already considered and distributed as property. As such, only maintenance awards premised on pre-tax baseline earnings will be non-duplicative. Chart 2 illustrates this point.



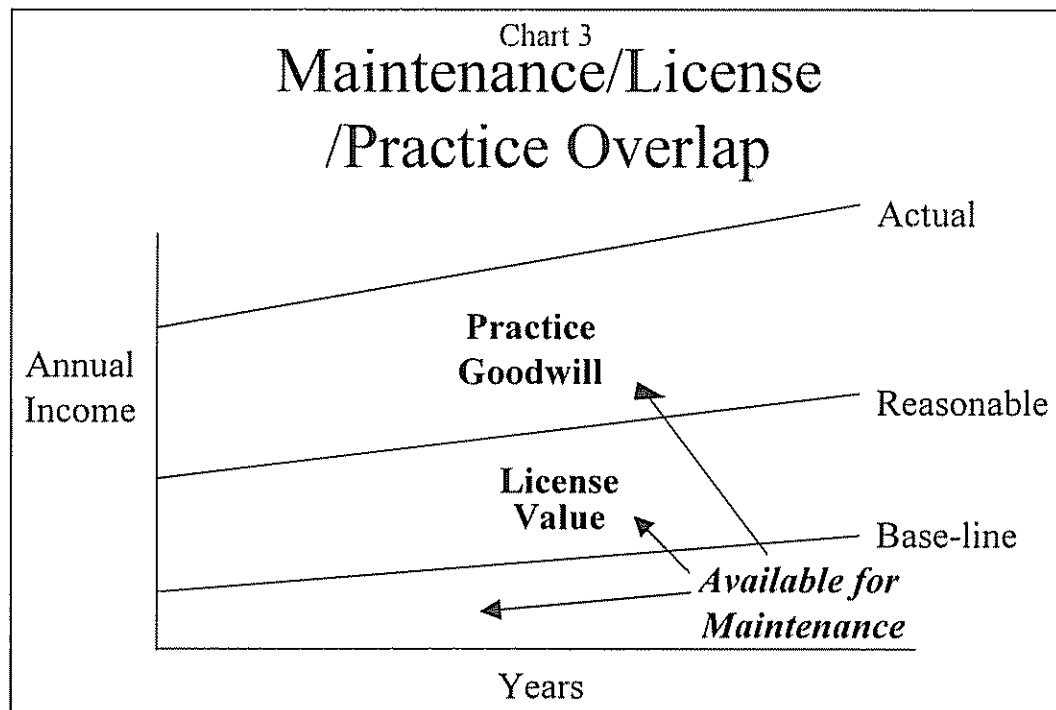
Interpreting *McSparron*, Law vs. Economics

McSparron cautioned against license awards which overlap the value of the practice, and maintenance awards which overlap the value of the professional license. This decision lacked commentary, however, on the potential overlap between maintenance and a practice or closely held business value and is completely silent regarding the issue of child support. As such, a published decision by Justice R. Friedman³ (*may he rest in peace*) holds that *McSparron's* warning against duplication does not extend to child support. Referring to chart 3, below, this position would consider not only baseline income in determining maintenance awards, but also the income which supports the license and practice goodwill values; essentially all income. As shown in chart 4, the decision would also consider all income as available for purposes of child support, distributed or otherwise, under the theory that if the Court of Appeals in *McSparron* meant to include child support as an area of duplication concern, then the court

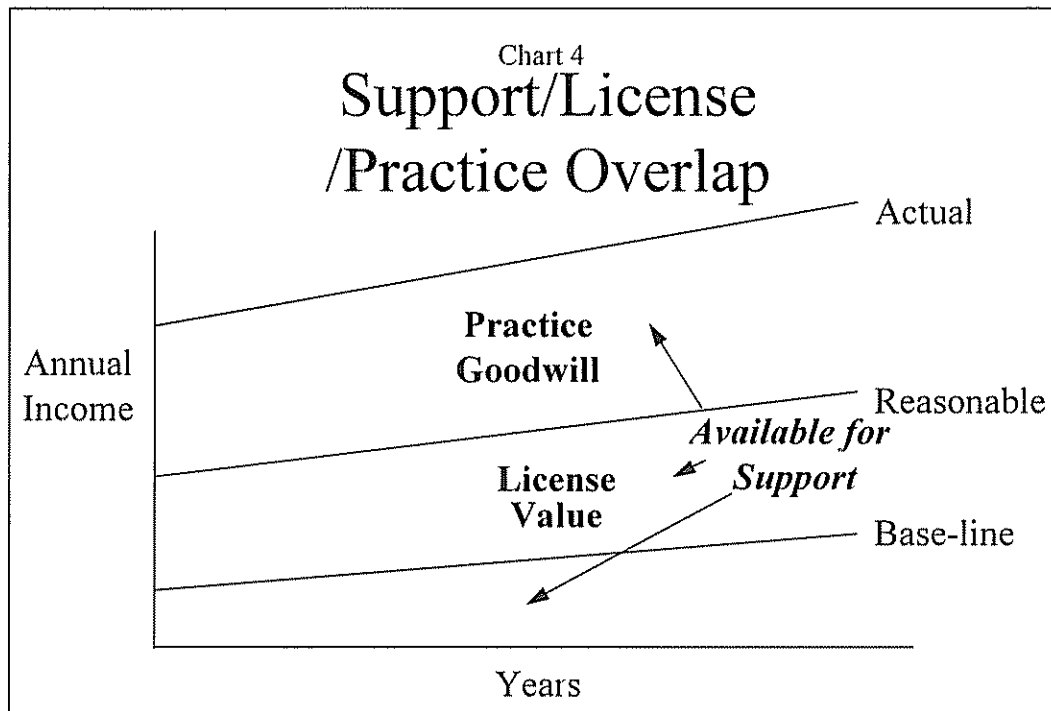
³ *Rochelle G v. Harold M G*, New York Law Journal, August 14, 1996

would have done so. This position is analogous to putting one's head in the sand to avoid having to deal with an economically and socially sensitive issue.

Awarding Maintenance Before Equitable Distribution



Disregard of Duplication Issues For Child Support



Additionally, the decision suggests that maintenance should be awarded first and, if it is determined that the award effectively encroaches on the income supporting the license and practice value, then, to that extent, value associated with the license and practice is extinguished. This is a very dangerous precedent especially when one analyzes the significant economic differences between a distributive award of property and spousal maintenance (alimony for tax purposes). Unfortunately, this approach has been embraced in other published decisions, much to the economic detriment of the untitled spouse.

Here are some of the differences between a property award and maintenance, some of which are permanent and cannot be compensated for:

- Property awards are non-taxable; maintenance is taxable.
- Maintenance ends on death or remarriage; no such contingencies apply to a property award.

- Maintenance is usually for a fixed period of time; property awards of a closely held business, professional practice or license encompass, at a minimum, the remaining worklife of the holder, which may be significant.
- Maintenance can be modifiable; a property award can not be modified.

It is clear to most that, in spite of the circular language in DRL§ 236 regarding the factors to consider in equitable distribution and maintenance, sound economics would suggest that equitable distribution awards should be made prior to maintenance awards. Only when one assesses the income that will flow from property awarded or the income inherent in the asset values of the property being awarded can maintenance decisions be made in a fair and equitable manner.

The economic motivation for *McSparron* is clearly a desire to prevent awards of license value and maintenance that are premised upon the same earnings stream. If the court fails to proscribe this overlap, it could allow combined awards which exceed the total income of the license holder. The inequity of awarding more than 100% of the license holder's income is readily apparent. Whether the overlap occurs between awards of the practice goodwill value and maintenance or child support payments with license and practice value, the economic implications are the same as those created by the overlap of license value and maintenance. To allow any combination of awards to overlap will allow combined awards which could exceed the total income of the license holder. To preserve the economic spirit of *McSparron*, it is necessary to extend the considerations specified by the Court of Appeals to include all awards, i.e. license value, practice value, business value, maintenance and child support.

Child Support

As to child support, we all understand and appreciate the need to care for the children of the marriage. To limit the amount payable from baseline earnings where a license and practice exist would be theoretically sound, but may not pragmatically meet the needs of the children. This problem takes on additional significance in light of such decisions as *Cassano*⁴ and *Jones v. Reese*⁵. These decisions (and others) support the courts' rights to consider all parental income in determining child support, not just the amount up to the statutory maximum of \$80,000. Failure to properly identify the areas of possible duplication and equitably reallocate income trapped in the values assigned to assets for equitable distribution purposes can result in significant unintended duplication. Through a process of attribution, however, income can be imputed to the non-titled spouse and subtracted from that of the titled spouse in an amount equal to the income computationally embedded in the asset value awarded through equitable distribution. This will at least balance the obligation between the parties even though the effect of this is to force the quasi "liquidation" of property to meet the children's needs. Such a result may be acceptable when the alternative is inadequate support for the children.

Closely Held Businesses

The problem of duplicative awards can also be present when distributing an interest in a closely held business. In many instances, a shareholder has a controlling interest and sets his/her own salary above the level which a valuator considers to be 'reasonable' compensation. In determining the fair market value of the business, the appraiser may adjust owners' compensation downward and, as a result, increase the income thereby creating value for the business. This is also done in valuing a professional practice. The excess compensation of the owner is essentially

reinstated to the net income of the business for purposes of determining its value. In a divorce proceeding, this business value may be distributed as marital property. When a reasonable compensation adjustment is made, some or all of the business value is derived from that portion of the owner's compensation which constitutes a return on his ownership interest, i.e. the excess compensation. If the court awards a fraction of the business value to the non-titled spouse, it indirectly awards a portion of the other spouse's income. The income that has been incorporated into the value of the business and distributed between the spouses should be identified when spousal maintenance and child support awards are being determined. This concept of duplication is really no different than that of a professional with a practice and/or license/degree.

To illustrate this point, consider the following example. ABC Company is 100% owned by Mr. Smith. ABC reports no net income, but Mr. Smith receives a salary of \$400,000 per year. A business appraiser determines that an appropriate salary for a position such as Mr. Smith's as a non-owner is \$200,000 per year. After adjusting Mr. Smith's salary, ABC Company shows net income of \$200,000 per year. The appraiser capitalizes the Company's net income at a 20% capitalization rate (multiple of 5) and arrives at a business value of \$1,000,000 for ABC Company. In the divorce proceedings, the court accepts this valuation and awards 50% of the business value, or \$500,000 to Mrs. Smith.

To grasp the duplicative award problem, it is important to understand the some of the subtleties of the valuation process which generated the \$1,000,000 value of ABC Company. First, to accurately represent the income producing capacity of the Company, the valuator adjusted Mr. Smith's salary down by \$200,000 per year, under the notion that an employee could

⁴ *Cassano v Cassano*, 85 NY2d 649, 628 NYS2d 10 (Court of Appeals, 1995).

⁵ *Jones v Reese*, AD3, 217 AD2d 522, 643 NYS 2d 311.

be found to perform the same services that Mr. Smith provides for \$200,000 per year, rather than Mr. Smith's \$400,000 salary. Accordingly, a portion of Mr. Smith's salary includes a return on his ownership interest. Next, when the valuator capitalized the adjusted income of the Company, he implicitly embedded the future income of the Company into the value. This expected future income, which produced the value of ABC Company, includes a portion of Mr. Smith's actual salary, the portion which was deemed excessive by the valuator.

So, how much of Mr. Smith's income is available for spousal maintenance and child support? Since the entire value of ABC Company was created by reclaiming \$200,000 per year of Mr. Smith's salary, that portion of his income has been incorporated into the value and awarded in the distributive process. In fact, Mrs. Smith's \$500,000 award can be directly linked to \$100,000 of Mr. Smith's annual income (50% of the amount deemed excessive). The proper approach for determining maintenance would be to consider only the \$200,000 of Mr. Smith's income which is deemed "reasonable" since the other \$200,000 has already been distributed as part of the business value. For purposes of child support, the court should recognize that by virtue of the property distribution, Mr. Smith's income has been reduced by \$100,000 per year and Mrs. Smith has effectively gained this amount of income *vis-a-vis* the property award. Such attribution is necessary to ensure a proper allocation of the child support obligation between the parties.

Summary

Whether the assets under consideration are a closely held business, professional practice or advanced degree, the key to a successful resolution to duplication is identifying the earnings which form the basis of value and factoring in those earnings into the determination of maintenance and support awards. In many instances, appraisals will cite methodologies which conceal or otherwise obfuscate the earnings base which supports the asset value, such as price-to-

book multiples, industry rules of thumb, replacement cost or market comparables. For this reason, it may be beneficial to retain a qualified valuation or finance professional to provide the necessary analysis. A qualified professional will be able to clearly identify for the court the earnings which support the value of the assets and assist the court in avoiding property, maintenance and support awards which are duplicative.

Mr. Johnson, a Certified Public Accountant, Certified Business Appraiser and Board Certified Forensic Accountant, is a senior partner with Bollam, Sheedy, Torani & Co. LLP, CPA's and serves as director of valuation and litigation for the firm. Mr. Johnson has performed hundreds of valuations of closely held businesses, professional practices and enhanced earnings and has testified frequently in support of his findings. He is a frequent author and lecturer on issues of valuation, litigation and financial matters involving matrimonial litigation.